Special Report 2012/07

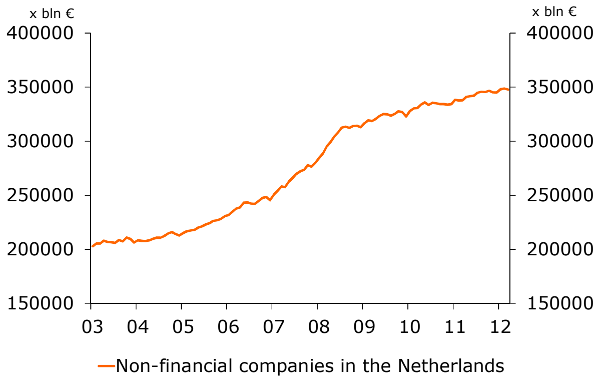
Is the credit tap on or off?

Consumers and businesses often need credit for large expenditures. Small- and medium-sized enterprises (SME) are, in particular, highly dependent upon banks for their financing. This makes continuity in lending crucially important to them. If lending were to stagnate, these entrepreneurs would take a hard blow. It would immediately have a negative impact on their ability to make investments, which would in turn hamper economic growth. In this Special Report we take stock of business lending in the Nether-lands and the factors that influence it.

Amount of lending

Banks in the Netherlands currently have approximately € 350 billion in outstanding business loans to Dutch non-financial com-panies. While there has been growth in business lending in recent years, it has been at a lower pace than before the crisis of 2008.

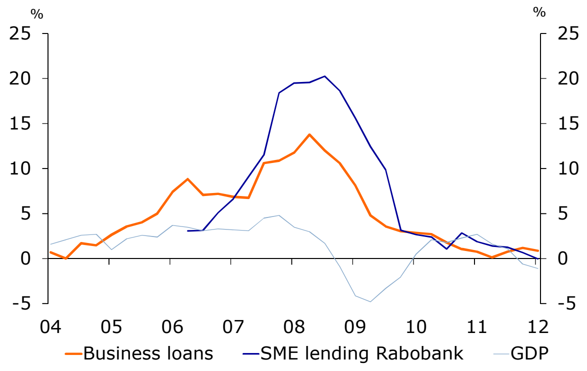
Figure 1: Amount of business lending



Source: DNB (adjusted for securitisations by DNB)

Even though the volume of loans to non-financial companies has risen by around 3% annually in nominal terms since mid-2009, there has been virtually no growth in real terms. There is, however, still no evidence that lending is shrinking, even though the Dutch economy has now dipped into a second reces-sion.

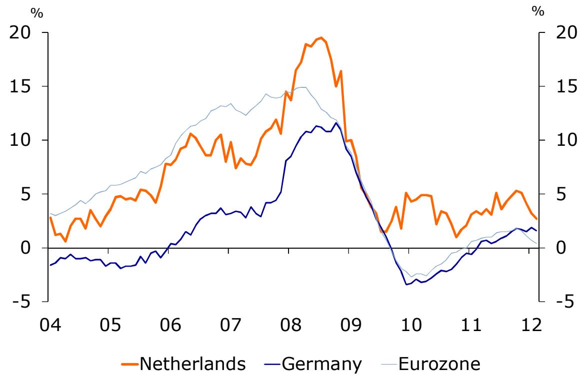
Figure 2: Real annual growth in lending



Source: DNB, Rabobank, Statistics Netherlands

The growth in lending in the Netherlands does compare positively to the rest of the EMU that has been experiencing a contraction in lending for some time now.

Figure 3: International growth in lending



Source: ECB (outstanding loans to non-financial companies in the eurozone, not adjusted for inflation and securitisations)

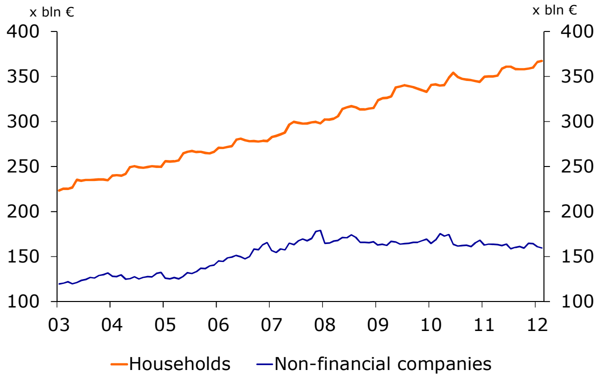
According to the European Central Bank's quarterly 'Bank Lending Survey', the cause of decreasing growth in lending should be sought more on the demand than on the supply side. Dutch banks say their acceptance standards have on average remained unchanged since the first quarter of 2010, with only a very few banks reporting that they have tightened their standards (slightly) since mid-2011. Most banks reported a drop in credit demand during the first quarter of 2012, chiefly due to a lower financing need for fixed investments, inventories and working capital. The credit demand is also forecast to fall during the second quarter of this year.

Relation to savings and capital market

Banks must raise funds in order to lend funds. Consumer and business deposits constitute a key source of funding.

Growth in household savings is stable. The nominal savings deposits of Dutch households have doubled since the start of the millennium: from € 180 billion in 2000 to more than € 360 billion in 2011, an annual increase of no less than 8%[1].

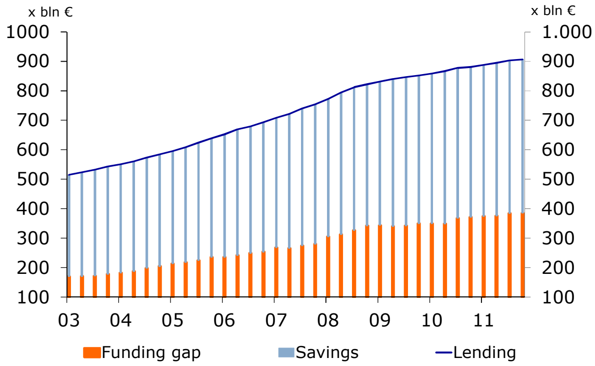
Figure 4: Household and non-financial company savings



Source: DNB, table 5.2.5

The savings behaviour of *companies* follows a more uneven pattern than that of *households*. The savings deposits of non-financial companies rose by more than 16% annually in 2005 and 2006, but have decreased since mid-2010. On balance, the savings of companies have fallen back to the level of five years ago. The combined savings deposits of households and companies are insufficient for financing the business and retail lending. This difference, i.e. the funding gap, has increased sharply in recent years. Dutch banks have consequently become increasingly dependent upon international capital markets for raising capital.

Figure 5: Funding gap



Source: DNB

As an alternative to raising capital, banks engage in *securitisation*, which entails bundling, repackaging and selling part of the loan portfolio. The loans are consequently removed from the bank's balance sheet, which means the bank needs less funding. Approximately € 95 billion in outstanding loans (mainly mortgages) have been sold to foreign investors (DNB, 2012). This represents 13% of the total outstanding mortgage amount.

Impact of regulation

During the aftermath of the financial crisis, a range of measures were introduced at the national and international level aimed at improving financial stability. Banks must, for example, fulfil the new liquidity requirements and stricter capital requirements laid down in the Basel III Accord.[2]

The objective of the *liquidity requirements* is to reduce the dependence on short-term external funding. Banks must consequently make proportionately greater use of stable funding sources such as savings deposits and long-term debt. They must also retain more liquid assets (assets such as cash and easily marketable bonds). The liquidity requirements contained in Basel III have not yet been completely worked out. The expectation is that securitisations held by financial institutions will no longer be counted towards their liquidity

[1] While a large proportion of the savings are withdrawable on demand, only a small percentage are actually withdrawn in practice.

[2] Refer to Rabobank Special Report: 'Basel III: tough but realistic'.

buffers because the liquidity of securitised products is considered to be less certain. The future liquidity requirements are currently impacting investor demand for securitisations, with already falling demand for long-term securitisations (DNB, 2012).

The objective of the *capital requirements* is to increase the banks' solvency by placing demands on the size and quality of the equity that they hold in relation to the risk-weighted assets such as loans. Basel III will go into force worldwide on 1 January 2013. The European implementation has been designed in the CRD IV Directive and is a step ahead of the worldwide implementation as banks in EU countries must meet higher capital requirements as of June 2012.
While the largest Dutch banks already fulfil the minimum solvency requirements, this is not the case in all the countries. If banks are unable to raise the required capital, the only option left will be to shrink their balance sheets by reducing their assets (holdings). This can be achieved by divesting certain activities and/or reducing the size of the loan portfolio. The IMF expects European banks in the years ahead to reduce their assets by € 2,000 billion. The IMF estimates that this reduction will be achieved in part by lowering the loan portfolio by € 500 billion, and is therefore warning of a European credit crunch.

While this warning is not directed at Dutch banks, the capital and liquidity requirements will also impact lending in the Netherlands. Because equity is more expensive than debt[3] and long-term debt is in turn more expensive than short-term debt, it seems obvious that lending will also become more expensive in the Netherlands.

[3] Equity holders must be compensated for the higher risk they run. In addition, the payment made to equity holders (dividend) is not tax deductible, while the payment made to debt holders (interest) is tax deductible.

The capital structure of banks

Banks create *equity* by retaining profits and issuing shares or – in the case of a cooperative bank – member certificates. Equity is a buffer for unexpected losses.
Debt capital is capital that must eventually be repaid to the lenders. The savings deposits of businesses and households form the most important source of long-term debt.
Additional long-term debt can be raised via means including issuing (covered) bonds.
Banks can also raise short-term debt on the money market or the interbank market. There are also *hybrid products*: convertible bonds that can be converted into shares during bad times.

In addition to these international regulations, new charges for banks will be introduced in the Netherlands. They include the proposed bank tax that will (most likely) amount to € 600 million a year and the contribution to a new fund for the ex ante financing of the deposit guarantee scheme for the amount of several hundreds of millions of euros a year. It will probably be possible to absorb part of these costs by, for instance, lowering operational costs and dividends (for a bank with shareholders) or raising variable interest rates and interest rates on new loans. But it seems neither feasible nor desirable to pass on a bill of hundreds of millions of euros annually to customers, employees and/or shareholders. Another possibility is to sell assets and to eat into the profit reserves. Slower growing or even lower equity, however, will also be coupled with less room for lending. The effect on lending is a multiple[4] of the reduction of the reserves.

The demands being placed on banks are consequently at odds with each other. On the one hand society expects banks to sustain the growth of their lending. On the other hand the

[4] The leverage ratio depends on the bank's core tier 1 ratio and the risk weighting of the loan portfolio.

regulatory authorities expect banks to further strengthen their balance sheets with a view to safeguarding financial stability.

Looking ahead

It remains to be seen how lending will develop in 2012 and 2013 if economic growth is absent and the impact of new regulations becomes apparent.

The state of the economy is crucially important with respect to *credit demand*. During a period in which economic growth stands at about zero for a prolonged time, lending in the Netherlands can ultimately be expected to tend towards zero. The *credit supply* is strongly influenced by the financial markets and regulations. What if the market for securitisations comes to a standstill? What will be the price effects if banks worldwide are forced to raise extra capital and sell securities? To what degree will the bank tax, inasmuch as the bill cannot be passed on to customers, employees or shareholders, lead to lower lending? To what extent will companies use alternative forms of financing such as leasing, credit unions, private equity, crowd funding or company bond issues?

All things considered, it seems reasonable to expect growth in bank lending to continue to fall in the coming period and the related prices to rise. While alternative forms of financing will grow in importance, many companies, particularly SMEs, are expected to remain primarily dependent upon bank lending. The best a company with an expiring loan can hope for is to be able to refinance it at higher costs.

Conclusion

The credit volume has increased in recent years despite the recession and the fact that the amount of savings attracted from households and businesses increasingly lagged behind. Banks are being torn in two directions: on the one hand they must fulfil their social role and on the other they are faced with higher expenses. Banks will only be able to continue to meet these contra-dictory requirements providing that they are able to increase their equity sufficiently and gain sufficient access to a properly-functioning international capital market for additional funding.

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